



C.D. Howe Institute
Institut C.D. Howe

Backgrounder

February 26, 1992

More Laurels than Darts for the 1992 Federal Budget

by

the Staff of the C.D. Howe Institute

The 1992 federal budget is framed in a credible economic forecast that still leaves more room for pleasant than unpleasant surprises. At this point in the business cycle, economic growth averaging 3.6 percent over the 1992-93 period looks achievable. From this perspective, any stimulation provided by the budget is likely — as has happened in the past — to add to demand once the recovery is already well under way. The RRSP withdrawal proposals, in particular, are designed to boost a sector that has already shown strong signs of recovery.

That said, the government's ability to hold the line in the face of massive pressure for fiscal stimulus and a huge revenue shortfall is commendable. Given the poor state of federal finances going into this recession, it is remarkable that the federal government's fiscal strategy has survived largely intact. Relative to the projections made in the 1990 budget, a year before the onset of the slump, the peak in the key ratio of net public debt to gross domestic product has been set back only one year, to fiscal 1992/93.

Given the tightness of monetary policy over the past three years and the current excess capacity in the economy — estimated in the budget at some 7 percent of potential GDP — it is quite possible that the forecast for inflation will, like last year's projection, prove too pessimistic. Barring a marked deterioration of the constitutional situation, the projections for real interest rates may also prove to

be too cautious. All in all, the prospect for more help for future budgets and the economy from even lower interest rates looks quite good.

On the face of it, operational expenditures — that is, excluding interest payments on the debt — for 1992/93 are lower than predicted in the previous budget. However, this improvement is mostly due to two bookkeeping changes. The merging in January 1993 of the family allowances (an expenditure) into the new child tax benefit (which will be netted against personal income tax collection) will "reduce" expenditures by about \$750 million. As well, putting federal pensions on a fully funded basis shifts about \$1 billion in payments — to cover indexing shortfalls — from a budgetary expenditure to a nonbudgetary transaction, a change that has virtually no effect on the government's financing requirement. Without these changes, growth in program spending in 1992/93 would have been 6.3 percent, instead of the 4.7 percent reported, a \$1.5 billion increase over the sums projected in the 1991 budget.

There are also genuine reductions in spending, the largest of which, \$575 million, is in defense. Overall, these reductions appear to have allowed the government to stay within the limits set out in last year's *Spending Control Act*. (The government has acknowledged that these limits will have to be recast to reflect the new bookkeeping.)

Even allowing for the reduction in revenues produced by shifting family allowances into the

new child tax benefit, the government's revenue shortfall for fiscal 1992/93, compared with its projections made in the 1991 budget, is enormous. Personal and corporate income taxes together will be \$7.5 billion lower than had been expected for the coming year, although the GST will bring in slightly more than expected. Thus, most of the projected deficit increase in 1992/93 is due to the functioning of automatic stabilizers in the economy — despite the balancing of the UI account via premium increases. Despite the increase in the projected deficit, therefore, on balance this budget is not throwing the fiscal plan off course.

Without passing judgment on the merits of each action, the budget's streamlining proposals — which will wind up, defer, merge, or privatize a total of 46 government agencies, boards, and other entities — illustrate a more constructive approach to spending control than the across-the-board freezes and cuts that have been common in the past. A clearer focus on setting priorities in expenditure is evident: an intent to manage public affairs more in the manner of private sector firms. The government's actions send a signal that public sector programs do not have indefinite leases on life.

The government responded to widespread calls for a special break to allow funds to be withdrawn from RRSPs and applied against the purchase of a home. The initiative will be available for only one year, and the stimulus it provides to the economy will impose little or no cost on government revenues. However, the proposal risks creating a precedent for future modifications to the RRSP program that could ultimately erode its integrity.

A promising measure is the reduction of the personal income surtax. Originally labeled a "temporary" surtax, this levy had taken on a permanent look, particularly when the commitment to remove it as an offset to the GST's introduction was not acted on. Given the increasing weight of taxes on Canadians, this reduction is a welcome signal that some of the fiscal dividend from lower interest rates will be passed on to taxpayers. A sour note on the

personal tax front, however, was yet another delay in increasing the RRSP contribution limits.

Other laudable measures include the efforts to improve the competitive position of Canadian firms through lower tax rates on manufacturing and processing, and higher CCA rates. Also valuable is the switch from subsidizing students who have completed their education or have defaulted on their loans to giving more support through the tax system for tuition. This could be the beginning of a move to channel more support for postsecondary education through students, complemented by a provincial move to allow tuition fees to increase to better reflect the personal benefits of postsecondary education.

The government has introduced a major restructuring of child support. Major improvements are the better targeting of assistance in terms of income and more timely delivery. In addition, the new federal earning supplement for low-income families with children is an important innovation in providing work incentives for recipients of income support. These two measures move the income-support system at the federal level closer to a guaranteed annual income of the negative income tax type. It may even be possible to use this small beginning as a way to integrate all taxes and transfers at both levels of government. It is unfortunate that in proposing this improved benefit package, the government has chosen to cancel the nonrefundable child tax credit. The end result will be to leave high-income families with children in the same tax position as a couple with the same income but no children. The enriched day-care deduction does nothing for families where one spouse takes care of the children.

Many of the initiatives in this budget — not all of which could be mentioned here — are relatively minor in their financial impact, but they indicate a new toughness and directness in program management. The budget also sends a refreshing signal that tax rates can go down as well as up. After eight years of restraint and frustrating setbacks, the process of fiscal consolidation may finally be bearing fruit.

Backgrounder® is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of immediate concern to Canadians.

As with all Institute publications, the views expressed here are those of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Copies of *Backgrounder* are available from the Institute at no charge. For further information, please contact: C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866).

Quotation with appropriate credit is permissible.